When and How

Selling Your Public Relations Firm

by Art Stevens

Published by
Consilium Books

Office: (732) 748-8583
Mobile: (917) 514-7980
http://theartstevensgroup.com

ISBN 978-1517495640
ISBN 1517495644

Book design by Wragwriter Ink

What they say about the author...

"Art has long relationships built on trust with most senior executives in the PR agency world. His advice is always objective and valuable."

— Richard Edelman
President and CEO, Edelman

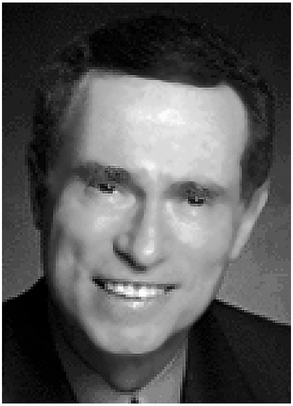
"Art Stevens is the consummate public relations professional, possessed of experience, good judgment and integrity."

— Harold Burson
Founding Chairman, BursonMarsteller

"Art gave me my start as an intern, which put me on the path to starting and growing my own independent firm. His wisdom and insights are invaluable to any owner or leader looking to optimize their firm for maximum return — either in a sale or going and growing it alone."

— Jim Weiss
Founder, CEO & Chairman, W2O Group

ART STEVENS



Art Stevens formed the predecessor firm to The Stevens Group in 2003 to consult on mergers and acquisitions in the public relations and marketing services industries. Before that he was the founder and CEO of LobsenzStevens, a prestigious independent public relations firm serving such major clients as American Express, Bristol-Myers Squibb, Principal Financial Group, Chrysler and Best Foods.

In 1999 LobsenzStevens was acquired by Publicis and Art stayed on to manage its New York office. He is a past president of the New York Chapter of the Public Relations Society of America and also served PRSA as national secretary and board member. He is the recipient of several lifetime achievement awards from PRSA including the John Hill, Patrick Jackson and Dorf awards. One of his previous books "The Persuasion Explosion" was must reading in a number of college and university public relations courses throughout the country.

He was also inducted into the City College of New York Communications Alumni Hall of Fame. Art has taught public relations at Fairleigh Dickinson University in New Jersey and lectured at the New School, New York University and the American Management Association.

He has been a keynote speaker at national conferences sponsored by such organizations as the American Bar Association, the Association of National Advertisers, the American Red Cross and the Florida Public Relations Association.

Contents

Preface

Why have I written this book? Because I made some mistakes when I sold my public relations firm LobsenzStevens to Publicis in 1999. At the time my firm was among the top twenty independent PR firms in the country and enjoyed a great reputation. I wish I could have had the guidance and help that PR agencies can avail themselves of today. However, the rookie errors I made in the process of being acquired have enabled me to guide and counsel public relations firms for the past eleven years to avoid the same mistakes.

I've saved countless PR firms from stepping into unfamiliar terrain ill equipped and unprepared. I've saved owners of PR firms from using poor judgment and choosing acquirers for the wrong reasons. A PR firm is a significant asset in the life of an agency owner and must be treated accordingly.

This book consists of blogs I wrote during the past several years for PRSA's (Public Relations Society of America) online issues of Tactics. I was invited to do so by the PRSA management team which felt, correctly that PR firms needed more guidance in making one of the most important decisions in their business life – how best to capitalize on the blood, sweat and tears agency owners put into starting a business and seeing it reach a certain level of success.

The world of PR agency mergers and acquisitions has changed dramatically during the past ten years. Criteria for acquisitions have changed, buyers' thinking continues to evolve and the role of PR agency owners in buyer organizations is far different today. Sellers need to consider a menu of options so they can make the wisest decisions on their future.

This book covers many aspects of how and when to sell a public relations agency. It is a straightforward tutorial enabling you to learn how to go about planning and consummating the sale of your firm. It is based on my experience during the past eleven years as managing partner of The Stevens Group and its predecessor organization.

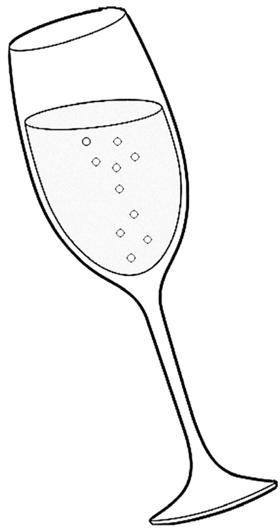
I have personally facilitated the sale of PR firms with revenues from $300,000 a year up to $40 million. The buyers have ranged from the big holding companies to regional marketing communications powerhouses. My job has been to make good matches. How this is done is the basis for this book. I hope my straightforward comments and observations are helpful to you.

I thank PRSA for its help in providing this service to the PR agency community.

Sincerely,

Art Stevens
Managing Partner
The Stevens Group

Chapter 1
So You Own a PR Agency?
Where Do You Go from There?



Let me propose a toast: Here's to those of you who took the plunge, who deserted calm waters to dive into the world of PR agency ownership. You could have stayed at your present agency or organization and hoped that proper promotions and salary increases would find their way to you.

But you told yourself that your dream was to own your own business and continue to do something you love — the practice of public relations.

Did you know that people are starting more PR agencies today than ever before? I attended the spring conference of the Counselors Academy and met a number of owners of recently established PR agencies.

My sincere congratulations to those of you who have joined the ranks of PR agency owners. And congratulations are also in order to those of you who have owned your agencies for more than five years. All of you, the newbies as well as the veterans, are now entrepreneurs in addition to being PR pros. And running a business is far different from anything you've ever done before.

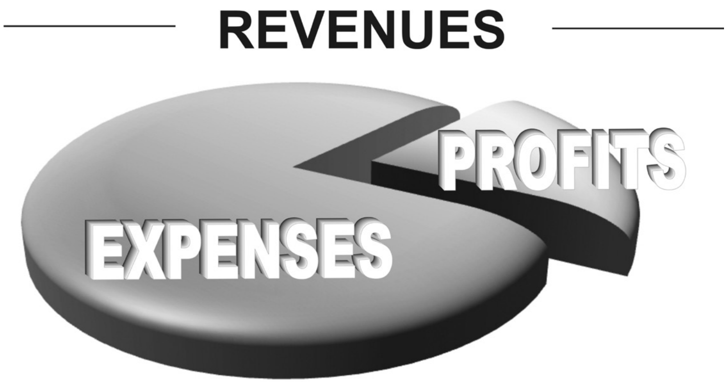
I know because I headed my own firm, LobsenzStevens, for more than 20 years. It got to be among the top twenty independent PR firms before Publicis acquired it. And for the past nine years, I've been facilitating mergers and acquisitions in the PR agency industry. I also consult with PR agencies and can personally attest to the fact that many agency owners don't know how to run a business.

Am I being unkind? When an agency owner who has been in business for more than five years tells me that she doesn't know what her bottom line is, then I know immediately that although she services her clients well, she hasn't made the jump yet to business owner.

The paradox is that most PR pros who start an agency want to sell it someday. What many don't understand is that if they can't get their businesses running like a business then an eventual interested buyer will pass.

Principles for Profit

In these following chapters, I'm going to tell you what you need to do to run your business as if you could sell it tomorrow. And even if you never sell your agency, if you follow these



principles, then you're going to make a lot of money anyway.

I'd like to start out by giving you a few basic principles that apply to those on the cusp of starting a business as well as those who have owned their agencies for some time.

Now that you're a businessperson, you need to understand how to control your costs. In time, you will need to rent office space and hire employees. And you will need to figure out what your profit goal is and what your own compensation should be.

If you've never done this before, then know that the planning can be arduous. But you must plan. You're now wearing two hats: one of a competent PR pro who is valued by clients and one of a business owner who wants to make money in the process.

Trust me. If you can do this for at least three years in a row, then you're a candidate for acquisition.

My predecessor firm conducted annual PR agency benchmarking surveys. The survey polled about 150 PR agencies. Its principal goal was to evaluate annual agency profitability. The results have remained comparable every year. The survey compares overhead costs as a%age of gross revenue. The prevailing profitability ratio for PR agencies is 20%. This means that you need to configure all your costs, including salaries, so that they are 80% of your revenue. If you can manage to run your agency this way — regardless of its size — then you can become that much closer to being acquired.

The key question now becomes how can you make your agency profitable? And the answer lies in how you apportion your costs.

Rules of thumb: Do not overstaff, do not over-service clients, and develop metrics to determine the profitability of each account and the billability of your account team. More about this later. But here let me offer the following advice: Don't start an agency if you aren't committed to running it profitably and doing all that's required to become profitable.

And begin to think about the next phase in your life, which could be anywhere from next year to the next five years. And that phase would be preparing your firm for an acquisition and working with new people. If you can picture that, then I will help you get there.

Chapter 2

You're Managing a Successful PR Agency What You Need to Know About Getting Acquired

Many of you simply want to continue to run your own agencies for as long as you can. Maybe you feel like you haven't been in business long enough to even think about selling. You're having fun, your business is growing and you have exciting clients.

To those of you in this category, I implore you to manage your business profitably so that if you consider attempting to sell your agency one day, then prospective buyers will be pleased that you knew how to run a business well.

To those of you who are considering the possibility of selling your business in the near future, let me throw out some questions that will test your appetite for exploring such a move.

How willing are you to give up your independence?

Would you be comfortable reporting to someone else after years spent only reporting to yourself?

Are you willing to be an employee of a larger company?

Can you live with the fact that you may be put out to pasture after your employment agreement with a buyer ends or that you would have to sign a non-compete agreement and couldn't restart your own agency for a certain time period?

If you can live with the consequences of these questions and still want to proceed, then let me paint the general landscape of current buyers and what their considerations are.

At one time, most of the PR agency buyers were the larger PR agencies themselves. With the rapid growth of agency revenues and client budgets, more buyers have come out of the woodwork than ever before.

Today's buyers continue to include the big holding companies like Publicis, WPP, Interpublic, Omnicom and Havas. But buyers now include considerably smaller regional PR agencies, ad agencies and marketing service firms. They also include international players, digital communications firms and private equity firms. Buyers are now often in the range of $2 million to $10 million in net fee income.

Many buyers are first time entrants in the acquisition front. They have made the strategic decision within their own boardrooms that growth can best be accomplished through both organic means and key acquisitions. And once new buyers enter the acquisition marketplace for the first time, they are inclined to do so again.

That is why there are far more opportunities for sellers than ever before.

What buyers want now

But one major change has evolved during the past 10 years.Acquisitions are now less about a seller seeking an exit strategy and more about continuing a career with a buyer's organization. Buyers are seeking strong entrepreneurs as well as strong firms.

And because there are more options for sellers, you can be that much choosier. Once you select a buyer and close a deal, you can't turn back. You're now obligated to work with this buyer for at least the next three years. How can you be sure you make the right choice? Here are some rules of thumb:

1. **Make sure that there is a strong cultural fit.**

To be sure of this, I always recommend that a seller spends a fair amount of time with the buyer's organization, particularly with the individual to whom the seller will report. The time to do this is before you sign a letter of intent, not after. Do a lot of due diligence on the buyer, organization, people, accounts, strategic vision, growth plan, track record and other recent acquisitions. Have conversations with the principals of other firms that this buyer has acquired.

2. Realize that acquisition terms are usually predicated on earnouts during a three to five-year period.

Be sure that the goals that the buyer sets for you to earn the maximum purchase price are fair, reasonable and attainable. Work with PR consultants who know the trends. Your PR agency is one of your major assets. Don't shortchange it.

3. Be clear about your role in the new buyer's organization.

The buyer will count on you to run your own operation independently — make sure that is the case — but you could play a senior management role in the buyer's organization. If you're interested in remaining with the company after your earn out period is reached, then you must lay the groundwork in advance.

4. Remember that a transaction is not only about money.

It's about a happy and exciting lifestyle with an organization that is in harmony with your own.

5. Protect and retain your key people.

These individuals are not only important to your welfare but also to the buyer's. They should be just as excited about the opportunities with the buyer as you are.

6. Analyze well in advance what you bring to the table.

That will help determine just how satisfied you'll be and if you can reach your financial goals. Are you in a niche that is attractive to the buyer? Is the city that you work in of value to the buyer? Does the buyer already have an office in your city or will your firm be its first one? Are there any major client conflicts that you would need to resolve or is there a perfect fit between your clients and the buyer's clients?

Chapter 3
The Sell Test

If you're thinking about selling your PR agency then here are ten important questions you should be asking yourself.

Ready to Sell

1. Have you made a list of reasons why you want to sell your firm?

2. Are you prepared to report to someone?

3. Do you have a realistic sense of the market value of your firm?

4. Will you be able to get alignment from your key senior managers?

5. Have you mapped out your plans for the future? For example, do you plan to retire, or stay on with the acquiring organization?

6. Is your firm in good enough financial shape to be of interest to a buyer?

7. Are you considering how your life might change if you were to sell your firm?

8. Do you have debt or liabilities that would make the sale of your firm more difficult?

9. Have you considered using professional counsel to help you make your decision?

10. Are you really serious about selling your firm? Or do you just want to go through the experience of having discussions with would-be buyers?

Chapter 4

Six Tips to Keep Prospective Buyers Interested

There are a number of common mistakes that could cause a prospective buyer to walk away.

We already covered the need to run your agency like the true business it is. And we posed specific questions to help you determine if you can transition when someone acquires your firm in Chapter 2.

We can now conclude that you're ready for acquisition and are preparing for the many meetings and deep scrutiny that you and your firm will now face. Expect prospective buyers to peer into your firm with a magnifying glass.

But before you start the rigorous exercise of due diligence, you need to make sure that the discussions get to that point.

Here's how:

1. Don’t play hard to get.

If you’re truly interested in being acquired, then let the buyer know that up front.

During my 10-year experience in facilitating mergers and acquisitions, I’ve seen a number of sellers make mistakes because they approach the first meeting expecting a prospective buyer to talk them into being acquired. This creates an awkward position for the buyer, who assumed that you took the meeting because that was not an issue.

Buyers aren’t going to waste their time trying to persuade an agency principal to sell. If you’re at the table, then come prepared to tell the buyer that you’re interested in having a discussion about selling your firm.

If you're not interested in selling, then don't take the meeting. Forget the hard to get act.

2. To negotiate the best deal for your agency, make sure that there aren't any individual accounts that are more than 20% of your total revenue.

Otherwise, the buyer will take the position that there's already more than enough risk in transacting an acquisition than to worry about a very large account terminating during the earn-out period.

It may pay for you to wait until you can get that large account down to a less onerous%age of your total revenues.

3. Have capable No. 2 people in place.

Buyers prefer acquiring PR agencies that have a deep bench beyond the principal's skills. As my firm specializes in facilitating PR agency mergers and acquisitions, buyers always ask us about the number two and three people.

Prospective buyers will carefully look at the key people who report directly to the principal and ask: Can we count on these people to provide top level management?

4. **Ensure that your financial statements are in good shape before passing them on to a buyer.**

   The care and professionalism shown in the preparation of these important documents will redound to your benefit.

   If you don't present these documents well, then the buyer will have second thoughts.

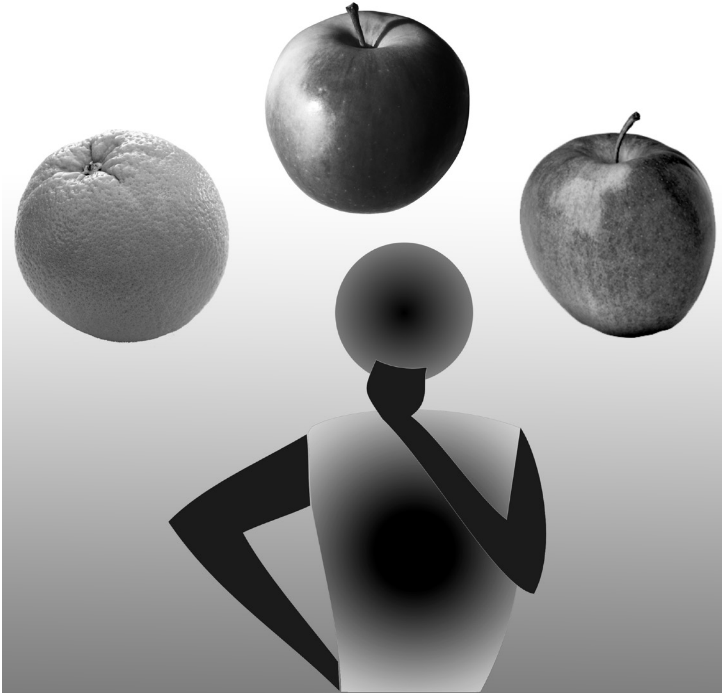
5. **Never show up late for a meeting with a suitor.**

In one instance, a seller and buyer had a solid first two meetings. Then, the buyer invited the seller to visit his team at his head-quarters in another city. The seller missed his flight and the relationship was never the same. Questions arose on the part of the buyer on the reliability of the seller, and that perception soured the relationship.

Be thoroughly businesslike in your dealings with a prospective buyer.

6. **Quickly provide a suitor with whatever information on your firm he seeks.**
   Don't procrastinate or plead the perennial deal stopper— you're busy now and will get to these requests as soon as you can.

If you don't consider such discussions top priority, then don't enter them.

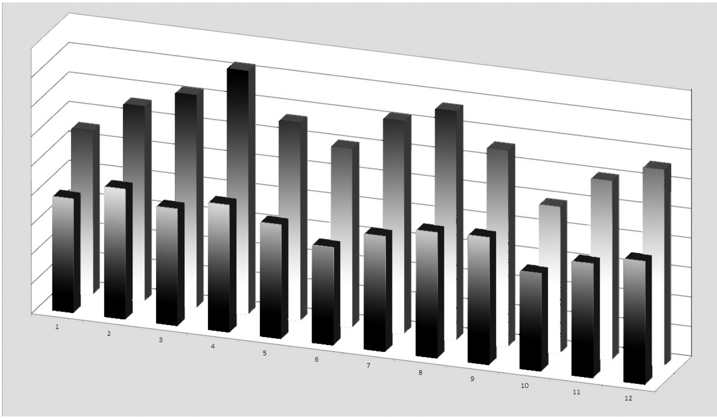


Chapter 5
Today's Acquisition Landscape

Once upon a time in the 1990s, there was a gold rush to identify and consummate deals with PR agency sellers. Technology PR firms were riding high, showing enormous profits and potential while leading the way to the PR agency acquisition revolution.

Every reputable PR agency was like today's sports free agent. Numerous bidders would romance the firms, and the highest offer won out. Often an agency owner would receive almost the entire purchase price right up front.

So if an agency earned around $4 million in net fee income, then the owner could receive that amount at closing. In addition, lucrative and easy-to-attain earn-out formulas were included, enabling the agency owner to receive an eventual purchase price of anywhere from three to five times its base revenues. A $4 million agency could eventually go for $10 million.



Not anymore.

Blame the dot-com implosion in 2000. Tech PR firms struggled, as did their dot-com clients. PR agency buyers accumulated large losses. Since then, deals have changed and buyers have learned to share more of the risks with the sellers.

The price is right

Today's acquisition landscape is considerably more sophisticated and discriminating. Deals are no longer conducted on the basis of showing financials first, before meeting in person. Culture and synergy are far more important to a successful deal today than they were in the late 1990s.

The financial structures have also changed. The current standard PR agency acquisition formula is still roughly one times revenues, which means that if an agency generates around $3 million a year, chances are that the ultimate purchase price will still be around $3 million.

The current base profit average for agencies of all sizes today is around 16%. That's down from almost 20% about four years ago. If a PR agency does considerably better than the standard industry profitability average, then the ones times revenues formula would no longer apply. For instance, if a PR agency shows a bottom line of 25%, then it could even sell for up to three times its present base revenues.

However, the caveat is that the seller would have to continue to produce those same levels of profit during an earn-out period following the acquisition. If the seller can continue to generate a profit of more than 20%, then the purchase price will increase accordingly.

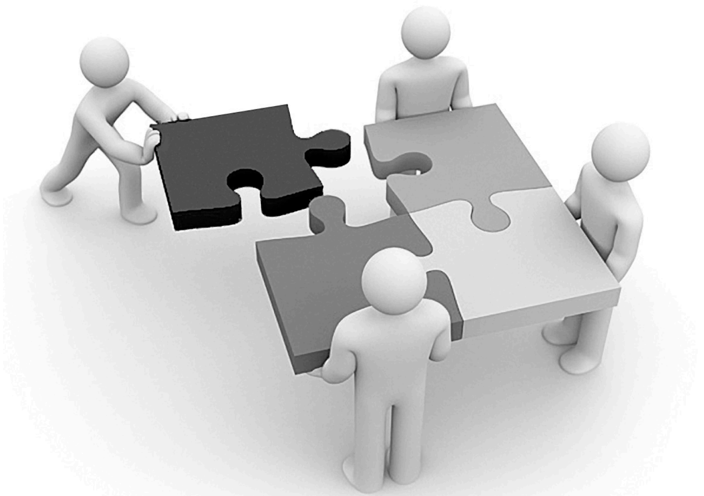
Most current deal structures are based on an upfront payment at closing and a three to five-year earn out. The more profit the seller has generated during the previous three years, the more the upfront amount will be. Upfront payments vary from 20% to as much as 50% or more — if the seller has profits in excess of 25%.

A win/win situation

The buyer’s goal, of course, is to purchase a successful PR agency that has a bright future that can be augmented through collaboration.

If it's the right fit, then everyone gains. A buyer with appropriate administrative and back office support can replace those of the seller. And if the seller can move into the office space currently occupied by the buyer, then more cost savings will occur.

As a seller, the key is to run your business profitably. That needs to start at least three years before you entertain acquisition discussions. Demonstrating a consistent pattern is more important than suddenly turning a high profit the year you become interested in selling your business.



Chapter 6

Profitability: Not No. 1 Consideration for Successful Acquisitions

Profits, profits, profits. By now PR agency owners understand the mantra of profitability and how important it is to be able to sell your firm. You've undoubtedly read about how firms are valued and what they need to do to make sure their finances meet the minimum acquisition requirements.

But lest we fall into the trap of declaring that numbers are everything, let me set the record straight. Profitability is important in the following way: it opens the door to acquisition discussions. It is not the be all and end all. If it were, then deals would be done sight unseen where a buyer reviews financials and makes an offer for a firm. There are far too many other important criteria for a successful acquisition.

In fact, I would venture to say that profitability isn't even the first criterion. It is probably fifth or sixth. Does this mean I am advocating that a PR agency owner minimize the importance of profitability? No. What it means is that there are far more important criteria.

It's been generally concluded that a PR firm should aim for a 20% profit. Does this mean that a PR firm that does 10% should remove itself from the acquisition marketplace until it does 20%?

Absolutely not.

A PR firm that does 10% profit may be just the right fit for the right acquirer. And the fact that the prospective seller isn't at the highest level of profitability may be of no concern to the buyer.

By joining forces, both the buyer and seller can embark on cost savings items like rent, administration, HR, accounting, technology and so on. But more important are the synergies, the complementary business, the management team and growth potential.

There is one caveat though. The seller would get a better financial deal if his firm did 20%

profit rather than 10%. But if the synergies are there and both buyer and seller buy into them, then the seller could still generate a meaningful purchase price.

With cost savings, the seller's profitability would take a dramatic turn upward. And with expected new business generated by both parties, the numbers could increase even more.

Consider this. There may be some very valid reasons why a PR firm's bottom line is low. It may have erroneously gotten office space that is considerably more than the industry average of rent being 7% of revenues. If it's 15%, then 8% of that amount is going into rent and not profits. Or the agency may be overstaffed for the business it has. Or the agency may have too many low paying accounts.

A Remedy

Here's what an astute buyer could do to help remedy these situations. It can help the seller negotiate with the landlord to get out of the lease with a reasonable penalty. It can take over the admin side of the seller's business allowing the selling agency's owner to focus on business development, clients and staff. And the buyer can help the seller generate greater proceeds by running the business more efficiently.

Many buyers can see well beyond the present state of affairs of a selling agency and that's why a lower profit margin isn't a deterrent at all. The most important component in any acquisition is the chemistry between the top management of both the seller and buyer. Without this chemistry even a 30% profit on the part of the seller can be meaningless.

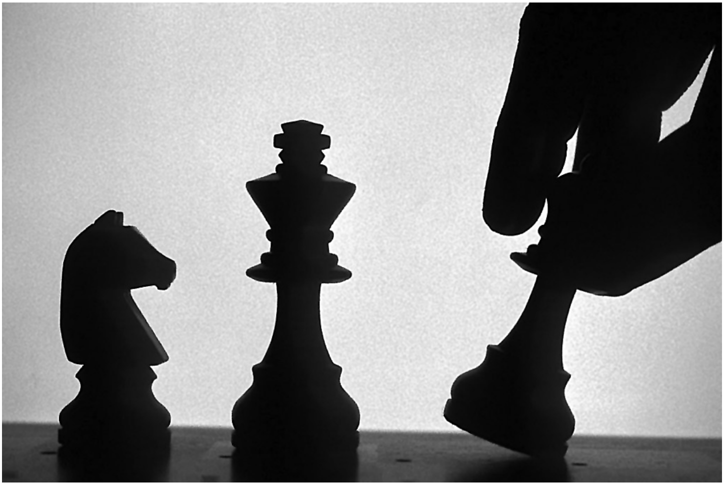
Given all this here are the top criteria in selling a PR agency in this modern marketplace:

Talent and expertise of top management
Talent and expertise of second tier management
Synergies
Niche
Client base
Geography
Profitability
Size
Culture

I have witnessed what you would call "distress" PR firms find a home and prosper thereafter. All they needed was a fresh start and a nurturing buyer. Some PR agencies get themselves into financial binds and don't know how to get out of them by themselves. Buyers can see through these challenges and develop a strategy for the sellers to turn things around and prosper going forward.

And, let's face it. Some PR agency owners are simply not good at running businesses. They're great at developing client programs, managing accounts and managing staff. But when it comes to running their businesses profitably — forget it.

There are great deals to be made by buyers who can see the forest for the trees. And there are great deals to be made by sellers without bearing the cross of 20% profitability.



Chapter 7

What Selling Your PR Agency Can Do for You

The most successful acquisition transactions that I've been involved with put a spring in the step of the principals of the PR agencies who have sold to larger buyers. It has less to do with extra money in their pockets. But it has everything to do with their new roles in the buyer's organization.

The best time to sell your firm is not when you're ready to retire — it's when you're ready to jumpstart your career. It's not when you can get the most money for your business, but when your future with a buyer's company can get you excited about public relations again. It's not when your profits are at their zenith, but when your zest for the next phase in your career is at its highest.

The current acquisition marketplace tells us the following: Buyers aren't looking for sellers to embark on an exit strategy; they're looking for sellers to partner with them so that both can achieve higher goals by working together into the future.

I have conversations with many prospective sellers all of the time. Among the beliefs that many still swear by are that they should sell their PR agencies when profits and revenues are at their historic highs, when they're ready to retire or work part time and when they can get the most money for their businesses. No, no and no. Not this time around.

The best time to sell your firm is not when you reach a targeted revenue number. It's when an opportunity to partner with a compatible buyer can enhance your life. The buyers out there are now considerably more aggressive in finding compatible matches than ever before. And, believe it or not, more sellers are connecting with buyers that haven't even offered the highest price. The reason? Lifestyle.

Buyer-seller compatibility

First of all, the demographics of buyers have changed drastically. Buyers are no longer the largest companies, but are the medium to small-sized ones. The bottom line is not the primary tool in evaluating the efficacy of deals anymore. It is more the fit that will determine if a transaction is destined to be.

As one buyer told me recently, “If the seller and I are compatible and are excited about what we can accomplish working together, then that means everything to me. The rewards will follow.”

Many sellers are unable to grow rapidly. They are stymied by the size that they have reached. Their lament is that they can’t get invited to compete for the larger accounts. This lament is actually the truth. But when partnering with a larger agency, the combined operation is able to compete on a higher level.

A buyer’s company should never be a graveyard for a seller’s firm, but a rebirth. That is what the current marketplace tells us. Gone are the days when the first step that a buyer wants to take when evaluating a prospective acquisition is to review the financials. Now meeting first and spending time together is more the bellwether. If there isn’t any comfort level between buyer and seller, then an evaluation of financials won’t even take place.

So when should a seller consider selling? At any time. Why wait three to five years if you can reap the benefits now? Size is no longer a prerequisite for most buyers. But niche, style, chemistry, talent, location and client base are. Even firms with revenues of well under $1 million can be of great interest to certain buyers.

There are many rewards for agencies that consider selling: being able to compete for larger clients, having the support of a larger agency's staff and resources, turning over the administrative/backroom/clerical chores to the buyer's team, getting to focus more on clients and business development — and there's an exciting future for the seller's staff as well.

Selling a firm is like creating an annuity for all team members. The legacy of the selling firm continues unabated. The owner becomes a key player in the buyer's organization. If the two cultures fit, then there is excitement, promise, opportunity — and a new spring in your step.

Chapter 8

Value Proposition: Are PR Agency Valuations Worth the Time and Money?

Let's say you're in the market for a new home. What do you do? You hire a broker to evaluate the current marketplace.

You give the broker information such as where you'd like to live, what type of house you want, what amenities need to be within driving distance and what price range you can afford. The broker goes through his database and identifies a house that meets your criteria. The house is listed for $300,000. That's the value that the seller and his broker put on the house.

When you see the house, you're excited. It's exactly what you want. But you don't think it's worth $300,000. So you offer $250,000. The two brokers negotiate to see if there's some middle ground, and when a phone call comes saying that the seller will accept $275,000, you're elated. You have your dream house.

The same premise applies to selling a PR firm. However, our profession has a process used to help determine the appropriate value of a PR agency. It's called "valuation."

A process that CPAs usually carry out, valuation examines a long list of tangibles, as well as intangibles. It includes a detailed analysis of past and present financials, profitability and client stability. It also evaluates the caliber of key employees, as well as that magic ingredient known as goodwill.

Let's say the founder of a $3 million consumer product firm finds out that his firm is worth $3.5 million through a formal process; that's what he should get for the firm if he sells

it. The PR agency owner will receive a bill from the CPA for a fee of $7,000 to $12,000 for conducting the valuation.

So just how "valuable" is this written valuation? This same PR agency owner decides to put his firm on the market. He deliberates whether he should sell to his own employees or to an outside organization, so he decides to test the waters.

He goes to three of his key employees and tells them that his agency has been valued at $3.5 million, and that he'd like to continue the legacy of the firm by selling it to them.

They are flattered, but after talking about it among themselves, they realize that they don't have the means to shell out that kind of money. So they offer the owner $2 million to be paid over 20 years.

The agency owner politely declines their counteroffer. After all, he's got the official valuation document in his pocket.

Then, he turns to the marketplace. He meets several potential buyers and displays the valuation document. He determines that there shouldn't be much in the way of negotiations because the value of his firm has been carved in stone.

One buyer offers him $2.8 million to be paid over three years.

"But you don't understand," the seller says to the prospective buyer. "I have a valuation and according to it, this firm is worth $3.5 million."

The buyer responds, "No, you don't understand. I've done my own evaluation of your firm, and my advisers and I don't think it is worth anywhere near $3.5 million. We believe it's worth $2.8 million."

The seller declines the offer and has a conversation with another buyer who says, "I believe your firm is worth $4 million and I'm ready to do this deal." Does the seller then say, "No, you don't understand. This firm is valued at $3.5 million, and I simply can't accept your offer of $4 million"?

No! The seller will simply toss the valuation into the dustbin of the restaurant where he's celebrating the sale of his firm and forget all about it.

A cost-effective valuation

My premise is simple. Don't bother with a valuation. It's not worth the expense. Just use the rule of thumb of how PR agency acquisitions are usually done. It's a lot cheaper. In fact, it doesn't cost anything at all.

If your agency has a net fee income of $3 million and a 15-to-20% profit after the owner pulls out all the perks, then the agency is worth about one times that net fee income — or $3 million. Or, it's worth five times your EBITDA; the prevailing totals are usually the same.

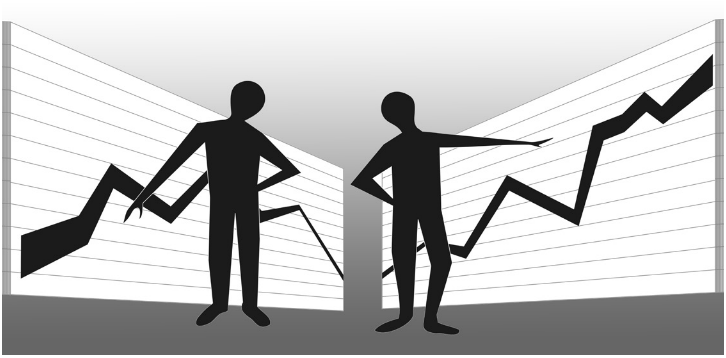
The only "valuation" you need to have is common sense. If your agency does around $3 million, then the base value will be around $3 million. If it has demonstrated rapid growth, and you are certain that the agency will double its size in three years, then the earn-out will take into account this rapid growth, and you will do considerably better than $3 million.

If your agency is stumbling at around $3 million, having made in excess of $4 million a year in net fee income the previous two years, then it may be valued at less than $3 million. But if the anticipated synergies take place between the seller and the buyer during the next few years and result in the seller experiencing a massive turnaround in net fee income and profits, then the seller could pocket more than $3 million after all.

You don't need an expensive crystal ball, tea leaf reader or valuation to give you this information. It's already there for you.

And I'll put it to you another way. I've been doing mergers and acquisitions for 11 years now, and I've never had a buyer ask to see a valuation. The buyer will always use his own criteria to make a judgment as to what a PR agency is worth to him.

And if a seller shakes hands with a buyer to move a deal forward, then the marketplace will have done the valuation for you.



Chapter 9

Debating the Future of Earnouts

Ever since a farsighted PR or ad agency determined that an additional way to grow its business was to acquire other PR agencies, the manner in which most transactions are completed today hasn't changed much since the ink dried on those precedent-setting M&A deals of yesteryear. Is that a good or bad thing? Let's take a look.

This dates back to when Bcom3 acquired MSLGROUP, Hill & Knowlton acquired Carl Byoir and Publicis Groupe acquired Lobsenz-Stevens.

The gold standard for doing deals was built around the "earnout," the term used to define the means by which the owners of the selling firm would be rewarded if it did well, and penalized if it didn't. The value of the transaction between buyer and seller was— and most often still is — predicated by a formula based on projected

revenue and profits for three to four years from the date of closing.

In the ensuing years, it didn't matter if the seller agency brought in wondrous new accounts, as long as other existing clients didn't go out the window and result in a revenue dip that exceeded the gains from the much-heralded new business wins.

It also didn't seem to matter what the working relationship was like between buyer and seller, as long as the projected revenue numbers were being met. Even today, there are buyers who are so transfixed on a seller's prior years' tax returns that they look to the financials before meeting the individuals who they will be working closely with for the next three years.

For far too long, the basic tenets of successful acquisitions—chemistry, culture and compatibility—have been forgotten. Many buyers seemed to conflate the standards that a company should use to evaluate the purchase of a creative, service-oriented entity, like a PR firm, with the accounting metrics that industrial enterprises commonly apply when acquiring an available spark-plug manufacturer.

A PR agency is not a gadget-maker. In the world of PR agency M&A, there isn't any industrial machinery, assembly lines or product inventory to factor into the valuation equation.

The only inventory that a PR firm has is its people and its clients. Period. Buyers tend to forget this, and instead, they perform due diligence rituals on a PR agency as if a firm is analogous to that metaphorical spark-plug manufacturer. It's not.

The earnout profitability

So how can this nut-and-bolts buyer evaluation mindset affect the concept of earnouts in the M&A space of public relations.

Traditionally, PR acquisitions are made on the basis of varying%ages divided into two stages. Stage 1 includes upfront payment to the seller. Stage 2 includes the predetermined incremental payments dictated by profit multiples, stretched out over a three- to-four year period.

When executed this way, the owner of the seller firm that has a profit margin of 25% will do far better at the bargaining table than the owner of a seller firm with a profit margin of 10%.

But does this mean that the more profitable agency always turns out to be a better deal for the buyer? Hardly. It simply means that the owner of the more profitable agency likely knows how to manage a PR firm.

Over the years, I've witnessed a number of situations where the more profitable agency loses more clients along the way than the less profitable one. The reasons for this vary. But often, client defection is a result of slavishly profit-centric policies on the part of management that lead to under-servicing and understaffing even their most valued clients. If you're a buyer, then is this what you really want? What if you are a very profitable, but poorly performing agency?

If so, then I say buyer beware. You could end up being disappointed when the seller begins to lose clients and some of its best people during the year following the acquisition. What appeared to be a prudent purchase decision on paper could turn into a lemon of a deal in the real world.

Conversely, would a buyer be better off acquiring a less-profitable agency — one with stable and happy accounts, and a staff that will propel it into the future — particularly in light of the synergies that almost inevitably accrue to the combined entity, as a result of the consolidation?

As I see it, though, the problem with traditional earnouts is that they're all about making high profits for both the buyer and the seller, and less about the quality of service. If a seller wants to maximize profits during the three or so years of an earnout, then he or she is incentivized to cut costs and staff — often at the seller's peril.

The seller will do whatever it takes to get that profit ratio up so that he or she can leave the post after the requisite employment contract expires with wheelbarrows full of money.

The buyer-seller relationship

You might ask then, if these are the dynamics of a buyer-seller working relationship for the three-year period following the closing of the deal, then how will that arrangement impact the eventual working relationship between the buyer and the seller?

Well, for starters, the buyer might be reluctant to refer business to the seller because it would mean having to pay the seller more in the short term. It could also result in the seller losing the people who made the firm attractive to the buyer in the first place.

At The Stevens Group, we believe that there is a better way to forge a business relationship between a PR agency buyer and seller so that the financial arrangements — while an important factor in any negotiation — aren't the only yardstick used to bring the two parties together. Let's not overlook the fact that buyers acquire PR agencies for the following reasons:

- To help achieve critical mass and growth above and beyond organic growth

- To embrace the talents and quality of additional professionals
- To immediately add complementary clients to their roster

- To establish a foothold in a complementary or similar niche
- To establish a presence in a different geographic area

- To enable the buyer to increase the profitability of his or her firm in tandem with the seller's

While risk on the part of both buyer and seller is still a significant consideration in the art of any deal, we try to be more inventive and suggest more accommodating acquisition models to the owners of the buyer and seller firms who we work with.

The newer models that we're hatching are designed to minimize risks and embrace other criteria in addition to profitability. Those criteria include revenues, account stability, buyer willingness to give more credit to the seller for buyer-driven new business, workforce stability and other intangibles that don't necessarily add to the bottom line.

Traditional earnout scenarios will eventually go the way of the Edsel — it's already happening — and that newer, more growth-oriented terms will bring PR agency buyers and sellers together for the long term.

Chapter 10

Why a Buyer's Vision Must Align With a Seller's Vision

In a number of articles I've written for PRSA over the years, one of the recurring themes is the importance of chemistry when reviewing the merits of combining two agencies.

I don't mean to sound naïve. On the contrary, it's more than a decade of real-life experience in the PR agency mergers and acquisitions world that has taught me to place chemistry a couple of notches above purchase price, which conventional wisdom mistakenly considers to be the Holy Grail for a successful merger.

In fact, I don't even put purchase price in the "place" position, given all of the changes occurring in the PR agency mergers and acquisitions marketplace these days.

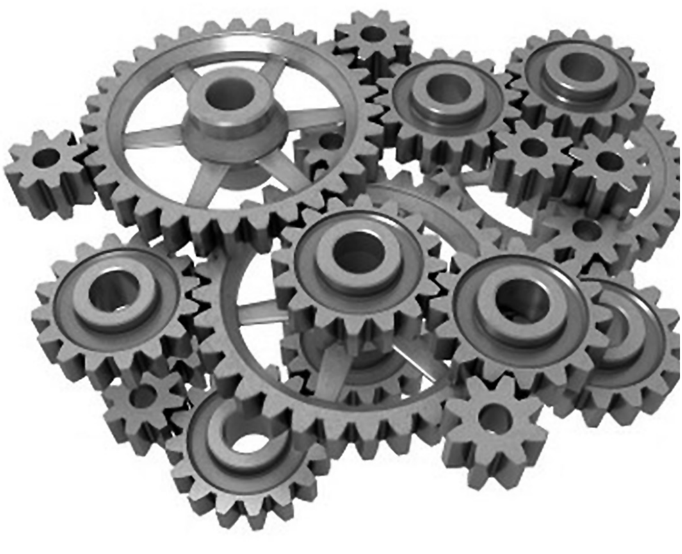
In my opinion, vision and the buyer's strategic direction ranks right alongside a good rapport as a vital criterion for joining forces with a buyer.

Here's why:

Strategic collaboration

There are more buyers out there than ever before. And their agencies' substance and shape change as often as an amoeba's does.

There are still the major holding companies, of course — Publicis, IPG, WPP, Omnicom and Havas, and there are also overseas buyers. Mid-sized ad agencies are adding PR services as another strategic arrow in their quiver, and smaller PR agencies are acquiring even smaller shops. More private equity firms are turning to public relations



and digital/interactive sectors as promising growth categories. And a series of "rollup" firms have now come onto the scene as well.

To be sure, there's nothing new about rollups. Peter Gummer pioneered the initiative when he founded Shandwick in the '70s and made about 20 independent agency acquisitions. All kept their own names for a period of time, until Gummer proclaimed that all Shandwick-acquired firms would lose their existing monikers and simply be called "Shandwick." Gummer then sold Shandwick to Interpublic, where it subsequently merged with Weber to become Weber Shandwick. Today, all of the rollup companies I'm aware of allow their acquisitions to retain their names, following the Shandwick model.

Renewed energy

In almost every situation where The Stevens Group is involved — plus every scenario that I'm aware of where we're not involved — the rollup company's game plan is to reach a certain size and then have a liquidity event, where it sells to a larger company or goes public.

The seller usually gets the opportunity to double-dip by reaping the benefits of an initial purchase price, while also in line to capitalize on the liquidity event down the road.

This takes us to the current mergers and acquisitions marketplace. Most current sellers don't want to sell and walk away; they want to stay. They want to jumpstart their careers and play an integral role in the new parent company by bringing all of their experience as agency founders and owners to the big stage. Successful entrepreneurs can continue their careers with renewed energy when a buyer of their choice acquires them.

Earnest discussions

My team and I always advise sellers to have earnest discussions with the buyer about the goals, direction and aspirations of his or her organization. If a seller is looking for a plain-and-simple exit strategy, and his or her deal is based on an earnout, then it's important for the seller to be certain that the buyer's organization has the financial resources to stick to the terms of the agreement.

But if the seller still loves the business and has the fire in him or her to continue working indefinitely (as most sellers are now doing), then the two sides need to agree on strategic direction for future growth, which can be the most important consideration for both.

A seller who is ambitious and wants to become part of senior management in an acquiring company is better off joining an organization that has demonstrated an ability to grow and manage its development through strategic hires, other acquisitions and expertise in the niches that it serves.

A buyer who is expanding his or her bandwidth by acquiring your firm for its special niche and

capabilities could be in a position to help a seller grow more rapidly. Remember that the seller's future must be tied to the buyer's future. That principle will help determine which route a seller should take when considering a buyer.

This is the future of PR agency mergers and acquisitions. The seller's continuing role has become just as important as purchase price, chemistry and culture.

Chapter 11
What's in a Name?

Here's an all too familiar story. The names have been changed to prevent awkwardness.

Rhett Butler Public Relations, a New York consumer product PR agency doing around $3 million in net fee revenues, was acquired by the Millard Fillmore Group headquartered in San Francisco. Fillmore, an agency on the rise, does around $30 million with a core of clients in most niches except for consumer products.

The agency decided to go the acquisition route. Its vision was to establish a foothold in New York, where it wasn't presently represented; and to get into the consumer product category to extend its service bandwidth. It identified the Butler firm as an opportunity to accomplish both goals. Through a facilitator like me the principals of the two firms met a number of times before both parties felt that the situation was right.

Terms were drawn up, negotiations ensued and agreement was reached. Butler was going to be the New York platform for Fillmore and both parties were ecstatic. The synergies were apparent, the culture was compatible and the chemistry between the principals was excellent. Legal documents were submitted by the acquiring firm, lawyers played their role in dotting the i's and crossing the t's – and the deal was done. Employees of both organizations were briefed on the exciting future this transaction would play in their lives. And announcements were sent to clients and subsequently the media.

All elements of the deal were included in the signed documents – except one. That was what the name of the acquired firm should be. They simply never discussed if the Butler unit would continue to be called Rhett Butler PR. Or Butler/ Fillmore. Or simply Fillmore.

For some reason the name of the acquired firm wasn't even raised in the initial and final discussions. All other components of the deal were: the earn out; the role of the acquired firm's principals; and the

reporting structure. The subject of the name of the firm was left hanging and needed to be addressed.

The Butler firm remained in the office space it had occupied for the previous ten years. When the deal was about two weeks done the CEO of Fillmore picked up the phone to call his counterpart at Butler.

"Hi, Rhett. I hope all is going well," said Fillmore. "Are your employees and clients as psyched about your joining our organization as we are?"

"Yes, indeed, Millard," said Butler. "Everyone is on board. It's a win-win situation for everyone."

"I'm so glad to hear that, Rhett. Now that the deal is done I think it's time to cover the next subject in our evolution. Since the Fillmore brand is so well known, I think we should now brand your firm as Fillmore. I'd like to see your name changed by the end of the month."

There was a long pause. Finally, Butler said, "But Millard, the Butler brand is also well known. We've established a strong presence in the consumer product category and if we abandoned our name it could cost us business."

“Nonsense,” said Fillmore. “If your brand is changed to Fillmore you’ll get more business not less.”

The conversation ended without any understanding reached. However, Fillmore continued to insist and Butler had no choice. In thirty days the name of the decades-old Butler firm was changed to Fillmore. And the firm suffered as a result.

If you were to have a private and confidential conversation with Rhett Butler about this turn of events, here’s what he would say: “We were in effect forced to change our name. It hadn’t occurred to me that this would be part of the deal. Once acquired, I no longer had a vote. Our employees were very disheartened to learn that the Butler name was gone. Worse still, our clients began to look more closely at possible conflicts of interest with those of the parent company.

“And for some reason our usual over-the-transom prospects began to shrink. They thought that once the Butler name was no longer on our letterhead that we had gone out of business. It was a disaster. If I had it to do over again I would never agree to abandon a brand name that was well known in the marketplace."

If you're contemplating selling your firm you should insist on your name being carried forward at least through the end of the earn out period. If your firm does well under $1 million in net fee income and you have fewer than ten clients a name change may not be that vital. But if your firm does at least $2 million in net fee income, has a dozen clients or more and a staff of twenty then the name of the firm is just as important an asset as how much cash you have in the bank. The optimum choice is to combine your name with that of the buyer –Butler/ Fillmore. The combined name could do more for your ongoing reputation as the name of your firm before the transaction.

Most buyers wouldn't agree to have its acquisitions retain their own names unless the buyers are huge holding companies. It's one thing for a Ketchum or Fleishman Hillard to keep their names as wholly owned units of Omnicom. But it's not likely that a pr agency the size of Rhett Butler PR would hang on to its original name. The more common likelihood is that its name would become combined with the buyer — Butler/Fillmore.

The important thing to remember is that the name of the acquired agency is no less important than other fundamentals such as purchase price, earn-out criteria, degree of autonomy and synergy. The success of the merger and certainly, your ongoing net fee revenues, could depend on it.

Chapter 12

An Industry Best-Kept Secret: The Personal Wealth of PR Agency Owners

With the spate of agency acquisitions in recent years, you might think making a deal is easy. Far from it.

As someone who has worked closely with more than a hundred public relations agencies during the past 10 years, I am privy to one of the best-kept secrets in the industry. Most owners of independent PR agencies, regardless of their size, are very wealthy.

This fact, and it is a fact, doesn't show up in PR agency benchmarking studies that include typical salaries of PR agency owners. These owners guard their best-kept secrets zealously and simply report what they consider to be industry standard salaries. But the profits they take out in the form of distributions during the course of the year are kept strictly confidential.

So if a benchmarking study reflects that the industry standard for an agency owner of a $5 million firm is a salary of, say, $300,000, you can be sure that this isn't the whole story. Most likely, that individual will be pulling out more than $1 million a year.

The enormous sums of money taken by most PR agency owners lies buried in agency financials. They are buried under the headings of various other categories. It's not uncommon for a PR agency owner of a $500,000 firm to take in at least $250,000. Nor is it uncommon for a PR agency doing $3 million in fees to generate almost $1 million a year for its owner.

If a PR agency with fee billings of $5 million does around a 30% profit, after all other overhead including staff salaries that generates about $1.5 million in profits. Guess who gets to keep most of that?

Consider this. A key number two senior manager in a $5 million agency may earn a salary of around $250,000. And I'm being on the generous side. This senior manager may manage many more professionals than the owner of a $500,000 PR agency. Yet the latter individual often takes in considerably more than $250,000 a year. Is it any wonder that more and more PR agencies are being started than ever before?

I am personally aware of one independent PR agency owner that earns more than $5 million a year. And the agency isn't even among the top 20 in fee billings. This individual earns more than the CEOs of holding company PR agencies. Ah, the joys of growing your own business.

The various economic downturns of the past 15 years tended to sober up agency owners. Some lost their agencies because they couldn't handle the dire steps necessary to keep their businesses afloat.

Yet, there comes a point in the lifetime of a PR agency owner when he or she would like to sell the agency. The question becomes how does an agency owner capitalize on the enormous profits the agency has generated in order for him to become as wealthy as he is? Can a buyer find a way to reward the agency owner with a purchase price that is appealing and still recognizes the enormous hurdle that would have to be overcome to generate more dollars for the owner than he's already taking on his own?

During my travels through the world of PR agency M&A, I've come across a number of primary reasons a PR agency owner wants to sell:

- He wants to cash out and retire.
- She wants to cash out and get into another endeavor altogether.
- He wants to jump start his career by staying on and becoming part of a larger organization.
- She wants to stay on but work less.

Taking as an example the owner of a $5 million agency who takes out about $1 million a year, how can an acquisition be structured that would accommodate the owner's present income base with a realistic marketplace value? Typical deals are usually based on fee income or bottom line, or both. Typical deals these days are one times net fee income or five times bottom line. So if an agency is doing $5 million and it generates a profit of $750,000 a year, then that agency could be worth around $5 million.

But if that agency is generating a profit of 30% and the owner takes $1 million a year, then in five years, that owner would personally take in $5 million. If he is offered even $7 million for his agency, then it's not economically worthwhile for the owner because he would net a mere $2 million for his agency. It's worth a hell of a lot more than that but buyers may be wary throwing around big bucks for a potentially uncertain future.

The truth is that it's easier structuring a deal for an agency doing a 15% profit than for a 30% profit. So given this interesting phenomenon in the agency business, how can deals be done for firms generating enormous profits and huge windfalls for their owners? Here are the criteria:

A buyer will bite the bullet and offer a generous amount of money up front and a value of more than two times annual revenue.

A seller will determine how much more he can live with as a net purchase price after he deducts what he himself can generate by remaining independent. For example, if a seller can earn $1 million a year as an independent and is managing a $5 million agency, he will earn $5 million on his own for the next five years. The seller and the buyer can reach a compromise by making the purchase price a minimum of $8 million, thus netting the owner an additional $3 million. The owner may be anxious to start another non-competing business and take leave as soon as possible.

A seller may want to abandon the headaches of back office responsibility – administration, HR, accounting, repairs, capital improvements, and the like – and become part of a larger organization. This seller may compromise on the value of his business in exchange for becoming an integral part of the acquiring organization's management team.

These are some of the ways in which compromises can be made to allow a seller and a buyer to close a transaction when the seller personally generates an enormous income. The seller must be willing to be flexible if the goal is to either exit or enter. Looking at it another way, the seller is already quite rich if he's run the business well. This doesn't mean that he wants to give the business away. What it does mean is that the seller may be so ready for the next major change in his life that he's willing to work with a desired buyer to make a deal happen.